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SUBJECT: SERBIA: Serbia: How the Economic Crisis could Lead to a Government Crisis

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SUMMARY

1. (SBU) Politicians in Serbia are facing the increasingly sober reality that the global economic crisis will hit Serbia hard this year. After initially trying to duck under the economic crisis wave, the political leadership is now resigned to the fact that Serbia must address the economic challenges ahead. So far the disorganized opposition has failed to seize the economic situation to make political gains, but there will be a political cost as the Serbian public faces an ever grimmer economic landscape. While a government reshuffle is possible this summer to cast off scapegoats, it is more likely that the coalition will hunker down, turn to populist rhetoric and blame the IMF -- and the United States -- for hardships. President Tadic has become more personally engaged on economic issues as he has realized the serious threat from the economic uncertainties of the coming year to the stability of the Serbian government. End Summary.

Mood Change with the New Year

2. (U) Serbia's economy slowed dramatically in the last quarter of 2008, but at the time the political leadership was still trying to paint a rosy picture of a Serbian economy that could avoid the storm in the developed markets and one minister even suggested that Serbia could even benefit from the crisis. As the New Year brought clear evidence of the depth of the economic challenges that Serbia will face, politicians have begun to take a more sober public line. They no longer talk of avoiding the effects of the crisis, but of mitigating or minimizing the crisis's effects.

3. (U) So far, few Serbian companies have been forced to lay off workers or close facilities. There has not yet been a wave of bankruptcies or business closures. The banking system survived the initial wave of financial pressure (ref A), and while banks have capital, few are offering credit to new customers and firms with weak financial positions find it difficult to refinance debt. Economists are revising their economic growth estimates for 2009 downward almost monthly. Last November our contacts suggested that 2-3% growth would be possible in 2009. In January most said Serbia would be lucky to grow by .5 or 1% in 2009. Now even the government has revised its official estimates downward and several leading economists suggest that Serbia's economy could shrink by up to 1% in 2009. On the streets people are concerned, but not sure how they will feel the crisis's effects.

U.S. Steel - Crisis Effects Clear and Growing

4. (SBU) U.S. Steel is one of Serbia's largest private employers, and was Serbia's largest exporter. Rick Vietch told the Ambassador in January that U.S. Steel did not have immediate plans to lay off

workers, but the firm had shut down one of its two blast furnaces, and would have already shut down the other if the gas crisis hadn't slowed the company's production in the first half of January. Vietch said the company's wage costs in Serbia were relatively low so they could keep the workers busy with maintenance and finishing work for steel brought in from U.S. Steel's Slovakian plant, but in the coming months the firm might have to consider layoffs or a shortened work week if orders did not pick up. As Vietch predicted, U.S. Steel announced on March 6 that they would implement a four day work week.

15. (SBU) Zoran Drakulic of the local mining conglomerate East Point Holdings told us on February 11 that March through May would be a critical time for the Serbian economy. Others we talk with point to May and June as critical months where the Serbian economy could be under extreme pressure.

#### Government Reshuffle Possible?

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16. (SBU) The active Belgrade rumor mill was filled with talk of new elections around the New Year, but now all governing coalition members are reiterating that this is not an appropriate time for new elections. The May-June timeframe that many contacts mention as a potential peak in pressure fits closely with the timing of the rumored government reshuffle. A shakeup in ministerial portfolios could make scapegoats of one or two economy related ministers, and perhaps cut the number of ministries from the bloated 24 existing ministries. The challenge of a reshuffle would be the very tricky task of rebalancing the delicate coalition balance among the various political alliances in the coalition. Our contacts said that if the government were forced to actually cut back on the bloated public sector and lay off public employees, it would be a sign that the

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situation had taken a very sharp turn for the worse.

#### An Opportunity to Blame Others for Hard Decisions

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17. (SBU) Leading DS party-connected figures Goran Pitic, chairman of Societe Generale in Serbia, and Aleksandar Vlahovic, member of Parliament and partner in Eki Investments, both told us that the crisis gave the government an opportunity to freeze public sector wages and pensions. The freezes would have a harsh affect on the public, but the economic situation gave the government an excuse to blame others, including the IMF, and would ultimately help to rebalance the economic costs to the budget of pensions and wages with needed funds for investment in infrastructure.

18. (SBU) Unfortunately, while the government has taken some steps to address the crisis -- boosting bank deposit insurance, establishing a program to subsidize interest rates and share risk for business loans, and seeking increased support from international financial institutions - there is not a comprehensive strategy or a clear economic leader in the government. Prime Minister Cvetkovic, Deputy Prime Ministers Dinkic and Djelic, and Finance Minister Dragutinovic all have strong economic credentials, but for different reasons each is limited in their ability to shape overall policy and lead the government and the public.

19. (SBU) The economic pressures on the budget also offers an opportunity to reduce the amount of money the Serbian government spends in Kosovo. Already the Serbian government has taken steps to reduce the salaries paid to Kosovo Serbs in Serbian government paid jobs from 200% of Serbian domestic salaries to 150%, and in some cases there are reports this will fall further. Cutting salaries opens the door to attacks from opposition parties claiming that the government is selling out Kosovo Serbs, but it is possible the government could calculate that the crisis pressure on the budget is sufficient to justify the political risk of reducing spending on Kosovo.

#### Effects Likely Deeper Outside Belgrade

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¶10. (SBU) Recently resigned State Secretary in the Finance Ministry Janko Guzian told us on February 12 that he believed Belgrade would be able to manage through the crisis, but that smaller cities in Serbia that were dependent on one or two factories as the engines of the local economy could face even more severe hardship or collapse as the economic climate worsened and some industries were forced to shut down or go into bankruptcy. In these small cities there were not alternative jobs or informal economy opportunities that could bridge the period until economic recovery began to emerge. Many smaller Serbian cities - the so-called "losers" in the privatization process -- have already been left behind in the Belgrade-centered economic growth of the past five years and now many see even the very small prospects for new investment disappearing.

#### Expectations Delayed Again

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¶11. (U) In other discussions with contacts, and with our own staff, many remind us that Serbs faced much more dire financial situations in the past and that many Serbs were capable of adapting to severe economic hardship, as they did in the 1990's. However, our staff noted that the Serbian economy was much different today and that many coping mechanisms used in the 90's would not be available to Serbs today with a more open economy. Serbia also lost much of its best and brightest as Serbs voted with their feet and left Milosevic-era Serbia. In addition, the Serbian public has suffered through continued delays in the high expectations that came in 2000 with Milosevic's overthrow. Since then, the political upheavals of the assassination of Prime Minister Djindjic, the seemingly endless election cycle, and the Kosovo crisis have all distracted successive governments from focusing on the economic future that other former Yugoslav and former Soviet-bloc countries have enjoyed since joining the EU.

#### Threat of Populism

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¶12. (U) Populism is a traditional theme in Serbian politics and during this economic crisis the pressure for politicians to resort to populist rhetoric and measures is significant. Populist and socialist rhetoric has been used by all of the major political parties and could become more common and more strident as layoffs and corporate bankruptcies increase. DPM Dinkic's recently floated proposal for government investment in the RTB copper mine is likely to find support among Socialists and former Socialists, who remember well the populist rhetoric of the Milosevic era, as well as the exaggerated "good old days" of Tito's Yugoslavia with its extensive

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social safety net. Senior DS leader Dragoljub Micunovic recently emphasized to us the need for the government to maintain "solidarity" with the people and to support the largest manufacturers and exporters.

¶13. (SBU) Serbian officials have welcomed foreign investors and regularly highlight the contributions of international firms to Serbia and Serbia's economy. However, there is a potential for politicians to blame international firms if widespread layoffs occur. One troubling indicator of the different treatment for international firms was that in January when U.S. Steel spoke with Srbijagas about the gas supply situation during the cutoff of Russian gas to Europe Srbijagas, and then later a government official both recommended that U.S. Steel contact the U.S. Embassy to secure additional gas supplies from Hungary.

#### Opportunity for Labor Unrest

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¶14. (U) In addition to populist rhetoric, Serbia also has a tradition of politicians manipulating labor unrest for nationalist aims. While talk of labor demonstrations has diminished following a peak near the end of last year, there remain potential flashpoints for labor unrest. The collective bargaining agreement (ref B) could be used later this year as an excuse for unions to launch protests against the government. Cutbacks in subsidies to agriculture (tobacco subsidy cuts already resulted in small protests in Belgrade

against the government), or on electricity and heating, or public transportation, could be used to rally support for demonstrations. These cuts could be blamed on IMF conditions or international pressure, but local political parties may seek to use protests to press a nationalist/populist agenda.

#### President Coming to Grips with the Crisis

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¶15. (SBU) President Tadic's comments at a March 1 session of the Democratic Party (DS) main board give some cause for optimism that Serbia's leadership is coming to grips with the magnitude of the looming economic crisis and is taking steps to weather the storm. Several sources have told us that in a closed session, Tadic harshly remonstrated several DS ministers by name - including FM Jeremic, MOD Sutanovac, Minister of Agriculture Dragin, and Minister of State Administration Markovic - for allowing their personal rivalries to spill over into state business and failing to coordinate with each other. Deputy Prime Minister Djelic told us on March 2 that the DS main board agreed that the government needed to stabilize the exchange rate, but the government has few tools to use in this effort. In his public comments, Tadic underscored the need for unity and said that early parliamentary elections would be an unnecessary burden on the country's economy during a time of economic crisis.

¶16. (SBU) Because Tadic consolidation of power in his hands has ensured that there are no other strong leadership voices in the government, he has placed himself in a position as the only player who can rally the entire team and set an agenda across the disparate coalition and the rival interests in the DS. Tadic has traditionally followed the path of his predecessor, Kostunica, largely ignoring the economy, instead focusing on political battles. Recently, however, Tadic appears to have recognized that he needs to have a better grasp of economic issues. In addition to meeting more regularly with business leaders, Tadic spent more than a day and a half at the annual conference of Serbian economists and business leaders (septel) at the Kopaonik ski resort, asking questions, seeking ideas and speaking frankly about the difficulties ahead.

Comment

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¶17. (SBU) Serbian politicians recognize that the economic crisis will increase public discontent and disillusionment with the slow progress toward increased living standards and closer relations with the EU. We expect this summer to be a peak in pressure on the economy and the government. The politicians now see the economic perils, but they have not articulated a comprehensive strategy to address Serbia's economic challenges. While a reshuffle of some ministers is possible to shift blame, it would be difficult to rebalance the delicately negotiated coalition. As a result, the government is likely to turn to increasingly populist rhetoric and point to the IMF as the bad cop, forcing tough economic choices to restrict spending. None of the governing coalition parties would gain from forcing new elections, and all seem now to recognize that fact. However, recognition of rational facts and political actions traditionally are not synchronized in Serbia. End Comment.

MUNTER